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COMPETITION POLICY IN SMALL ECONOMIES

-- ESTONIA --

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ESTONIA

COMPETITION PROBLEMS IN A SMALL COUNTRY

A small country is usually defined by absolute numbers using different variables like population, GDP, size of the markets etc. Obviously no uniform borders cannot be drawn between small and large countries. In terms of competition policy the “smallness” of a country depends on actual characteristics of a specific market. The larger the MES of an industry is, the bigger size a country has to have in order to qualify as large. Besides the absolute numbers the definition of a small country depends on the nature of its business relations with other countries. If the business decisions and trade flows of one country affect significantly another country and not vice versa, there might be the relationship of a big and a small country. A small country that is surrounded by large countries with large companies experiences a significant foreign impact on its domestic competitive situation. For example, Finland has with some reservations the impact of a big country on Estonia as a small country. Business decisions made in Helsinki have an enormous impact on the competitive situation in Estonia whereas Estonia rarely affects the balance on the Finnish markets. It is notable that both countries are usually regarded as small countries in a global scale. Besides the size difference of the countries this situation is escalated by the fact that Finland has a highly developed economy with powerful companies while Estonian companies have emerged during the past 10 years. The level of development of a country correlates with the impact it has on other countries.

It is obvious, that the number of companies that could act in a market is a function of the size of the market and minimum efficient scale. Therefore it might be the case that in a small economy in some sectors the number of enterprises can be limited to the extent that raises monopoly problems. In those cases there is a trade-off between the efficiency gains from scale and from residual competition. The economics gives no uniform method how these two factors should be weighed in terms of competition policy, each case should be dealt individually. In theory, the cost of an additional market participant (i.e. the fixed cost of an additional production unit) should be weighed against the likely welfare loss from the more concentrated market structure. Although simple in theory, it is very difficult to perform that analysis in practice. However, it is clear that the cost of an additional market participant tends to be relatively bigger in small economies.

Despite of the significance of the MES consideration in a small economy most of the competition laws have the stress on keeping a viable competitive structure in the markets. Estonian competition act states that a merger will be prohibited if it may create or strengthen a dominant position as a result of which competition would be significantly restricted in the goods market. The competition act also states, that the appraisal of a concentration shall be based on the need to maintain and develop competition, taking into account the structure of goods markets and the actual and potential competition in the goods market, including

1. the market position of the parties to the concentration and their economic and financial power and opportunities for competitors to access the goods market;
2. legal or other barriers to entry into the goods market;
3. supply and demand trends for the relevant goods;
4. the interests of the buyers, sellers and ultimate consumers.

The given provisions demonstrate that the Estonian competition act has clearly its stress on the competitive structure of the market leaving little room for the efficiency considerations. The Estonian Competition Board cannot therefore approve a merger barely on minimum efficient scale justifications, residual competition must remain sufficiently big. However, the Competition Board recently approved a merger in the dairy sector, which resulted in a new company that has a significant market power. One of the arguments for allowing the merger was that in that way the parties would achieve the size necessary for coping in the EU internal market.

There are other peculiarities of a small economy besides the fact that its markets are very small. The smaller countries are significantly more dependent on international trade. The volume of international trade as opposed to the GDP is usually much higher in case of small countries. For example, the added volume of import and export as a percentage of GDP is 99% in the Netherlands, 48% in Germany and 19 % in USA (source: CIA World Factbook 2002). Higher openness to the international trade means higher dependence on international competitive pressures. A typical small country with a liberal trade regime produces a limited number of commodities, which are exchanged, with the rest of the world for a large variety of commodities needed in domestic consumption. Therefore, a majority of the markets in the small countries comprise imported goods only. In the case of Estonia the number of markets solely or even partly supplied by the domestic goods is very limited. Even the markets that are supplied by our most prominent industries, like the furniture industry, face very strong competition from abroad.

The large number of markets solely supplied by the imported goods means that the MES considerations do not affect the competitive situation in many cases despite of the small size of the country. The MES leads to concentrated market structures primarily on the production level while the distribution level experiences less economies of scale. On the other hand, the competition problems related to the production of those goods is out of the reach of the authorities of those countries. On a market solely supplied by the imported goods typical competition problems of the distribution level like the vertical restraints might emerge. Therefore the competition authorities of a small country must pay special attention to the restraints appearing in the importing sectors. The cooperation of competition authorities of different countries like it is planned among EU member states is of utmost importance to the small countries.

The high degree of openness to foreign trade must be dealt together with the fact that the small size of the country has an ambiguous effect on the entry barriers of its markets. On one hand, a relatively significant MES might be a serious obstacle for a newcomer because it has to gain a large market share from the existing undertakings in order to become sufficiently efficient. On the other hand, for a major international company entering a small market is far easier than entering a large market. Firstly, entering a small market requires smaller investment; we can argue that in some cases they can do it with the existing production facilities. For example, probably non of the major European car manufacturers would have to invest into additional production facilities if they would try to increase their market share in Estonia. Secondly, the risk of failure in a small country is far less fatal for a large company; it is able to survive the losses in a small market. The Estonian experience tells that major foreign companies tend to be willing to give their local subsidiaries significant financial assistance in order to gain or maintain a market share. For example most of the major West-European gasoline retailers have experienced continuous losses in Estonia because of the fierce competition. As another example, some years ago there was a wave of concentration in the Estonian banking sector, which resulted in a situation where efficient competition became questionable. Instead, some of the small banks belonging to major foreign banks started to increase their market share, which has had a arguably a positive effect on for example the interest rates. It can be concluded that in a small market large international companies tend to have much more market power than the traditional criteria like the market share would otherwise suggest. Therefore they may have a positive impact on competition. This rationale was followed in the dairy merger case mentioned earlier, where the Estonian Competition Board reasoned that despite of the large market share of the merged parties some smaller dairies have significant economical and financial power.

The importers can easily outweigh the small size as a low entry barrier by introducing vertical or horizontal restraints in the distribution. Therefore, the competition authorities must be watching out for these conduct infringements in order not to lose the advantage of low entry barriers as opposed to the disadvantage of small size. The small size of the markets with MES often result in stronger tendency to vertical integration to neighboring markets. In Estonia the independent companies operating on various non-banking financial markets, for example the pension funds seem to have difficulties competing with the subsidiaries of banks. The banks have an advantage of MES while operating the pension funds because the fruits of their main activities can be used on neighboring markets.

In the environment of flourishing international trade, there are a limited number of sectors small countries like Estonia are specialized in and which conclude the exporting industry. Industries like those often contain enterprises that are the sole operators in Estonia. For example, we have very large enterprises active in mobile telephone production, ship repairing, chemistry etc. In Estonia, like in many other countries, enterprises having a very large market share qualify automatically as the dominant ones. The common feature of those enterprises is that they are to a very small extent linked to the domestic markets and are totally dependent on the international competitive situation. As far as these enterprises have little if no impact on the domestic competitive situation the competition authorities normally should not deal with those. It can be asked whether, as a general rule, the markets should more often be defined beyond national borders in the case of small economies?

However, it might happen that those big exporting enterprises abuse their monopoly power on neighboring markets. For example, the Competition board has concluded that the Port of Tallinn, which generally faces international competition, has distorted competition in the market of providing infrastructure to competing terminals.

Besides the internationally importing and exporting sectors there is a third type of sectors in small countries, which consist of non-tradable goods. The MES considerations are especially relevant in these sectors. In theory, whenever the economies of scale appears, the outcome would be a sole operator in the market. Nevertheless, although most of the industries experience economies of scale to some extent, an absolute monopoly is rarely the outcome. This fact can be explained by two reasons. Firstly, at certain volumes of production, the economies of scale becomes insignificant or even negative (i.e. diseconomies of scale). That mechanism has less effect in the small markets because of the MES problem. Secondly, the variety of consumer preferences exists within the markets regardless to the size of the market. The variety of consumer preferences creates demand for a number of products usually produced by different companies. For example, there are 3 national TV channels in Estonia, which many believe is economically too much for a country of 1.4 million inhabitants. It is the variety of consumer preferences that has resulted in 3 TV channels. If the lower level of concentration in a market is caused by the variety in consumer demand, there is no welfare loss although the aggregate production costs are higher and the efficiency of the producers is lower than in the large countries.

In conclusion, although the MES problem affects negatively the competitive situation in a small country, there are some mechanisms that counterbalance that effect to some extent. Small countries are to a larger extent opened to international competitive situation. Therefore, they can relatively more enjoy the fruits of international competition. Also, the small size of a country in itself may be under some conditions a low entry barrier for large foreign competitors. The variety of consumer preferences might affect positively the competitive structure of a country.